CROATIA

DEFINING AN AGENDA OF TECHNICAL ASSISTANCE IN HOUSING FINANCE

Prepared for

East European Regional Housing Sector Assistance Project
Project 180-0034
U.S. Agency for International Development, ENI/EEUD/UDH
Contract No.EUR-0034-00-C-2033-00, RFS No. 71

Prepared by

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EXECUTIVE SUMMARY

As part of USAID's developing program of technical assistance in Croatia, a preliminary assessment of the Croatian housing sector was completed in March, 1996. It identified nine issues and constraints affecting the sector. This report develops a more specific set of recommendations with respect to technical assistance in the area of housing finance.

An important part of the urban population, in particular newly forming households, is experiencing a drastic change in regard to the acquisition of housing. In the past, over a third of urban households received a housing unit from an employment-related fund, and title remained with the employer. Recently, nearly all of these units were sold to those holding the rights to living in them.

Along with the tenure structure in rural areas, which is overwhelmingly single-family owner occupancy, housing privatization has made Croatia almost exclusively a country of homeowners. However, not enough has been done to replace the old system with a new system for financing the next generation's access to homeownership, which require households to accumulate substantial down payments and secure long-term mortgages.

The situation is stressful for younger Croatians and their parents. The same stresses have arisen in other transition countries and many countries have resorted to a number of subsidies and special programs to address the tension. However, building a system of housing finance for the future is the only long-term solution, which is why finance (and subsidy reform) has received significant donor assistance in some other countries.

However, Croatia is different from most other countries in several very important positive aspects:

(1) it does not have a tradition of government (as opposed to employer) subsidies to individual home purchases;

(2) it has a better developed system of banks interested in making housing loans;

(3) bankers do not consider loan defaults a major problem;

(4) it has a relatively strong tradition of private rental units;

On the other hand, the country does have a severe shortage of domestic capital due to a combination of unique circumstances related to the war and economic transition.

Thus, the context for coping with the transition is different. The problems are **not** those of rationalizing and targeting existing subsidies, or of encouraging entry by more lenders, or of young households having no alternative housing options, or of serious credit risks.

What does Croatia need to improve housing credit opportunities?[1] More than anything else it needs less competition for banking sector funds by the loss-making enterprises. It needs restructuring of the banks currently burdened by such bad debts and increased confidence in the banks as repositories for household savings. As these things happen, it appears likely that banks will turn towards expanding their housing credits, since these are perceived to offer a better risk-reward ratio than most commercial lending.

There are two areas of Technical Assistance that would help the process and help meet goals of democratization and structural development of the financial system.

> **Recommendation 1**: USAID/Zagreb should attempt to expand the policy dialogue in the area of subsidies and housing finance. Short-term TA should be introduced when possible and appropriate.

There are valid arguments that the government should subsidize the home purchase of the young households most severely impacted by the change in systems. The Government appears to be considering some ideas in this regard, including the Austrian contract savings model that has proven so costly to the Czech and Slovak Republics. Although offering subsidies should not be endorsed explicitly, neither should it be condemned and TA should be used to try to keep subsidies as effective and targeted (and thus small) as possible and to encourage an open policy dialogue. This will not be simple, since there is no clear allocation of policy responsibilities in this area within the Government.

> **Recommendation 2**: USAID/Zagreb should encourage creation of a mortgage-related bond mechanism, possibly in the form of a liquidity or refinance facility.

Such a facility would allow the smaller, private banks to lend more and force the improvement of financing options through competition. Mortgage-backed securities might even be able to attract foreign capital. TA directed to the banks and the Ministry of Finance would be needed to help prepare a range of options in this regard and possibly in the initial implementation.

As the earlier housing sector report noted, the housing sector as a whole has a number of other pressing needs.

RECOMMENDED TECHNICAL ASSISTANCE ACTION PLAN:

Housing Policy Dialogue

Results:	Rational subsidy policies (other CEE countries have adopted wasteful subsidies) and other interventions
Clients:	Ministry of Physical Planning, Construction and Housing; Ministry of Finance; Ministry of Social Welfare; Parliament; Selected Cities and Banks
LOE:	3 person months expat STTA
Time Frame:	2 years
Outputs:	Policy Seminars, ad hoc analyses and on-site TA, housing policy "working group"

Financial Sector Innovation; Mortgage-Backed Bonds

Results:	Increased mortgage lending, longer maturities, more competition (especially smaller private banks)
Clients:	Ministry of Finance, banks, National Bank of Croatia, Ministry of Physical Planning, Construction, and Housing
LOE:	5-10 person months, depending on abilities of local TA to implement the program
Time Frame:	3 years
Outputs:	Mechanism for issuing mortgage-backed bonds (Federal Home Loan Bank or German mortgage bank model, not Fannie Mae)

CROATIA
DEFINING AN AGENDA OF TECHNICAL ASSISTANCE IN HOUSING FINANCE

INTRODUCTION

As part of USAID's developing program of technical assistance in Croatia, a preliminary assessment of the Croatian housing sector was completed in March, 1996. It identified nine issues and constraints affecting the sector. Although the report did not rank these by order of importance, USAID/Zagreb judged that, as has been the case in other transition economies, the underdevelopment of private-market financing mechanisms may be one of the most pressing of these problems.

This report examines that proposition and develops a more specific set of recommendations with respect to technical assistance in this area and, in its annexes, provides a more thorough analysis of the current operation of, and constraints on, housing finance in Croatia.

BACKGROUND ON HOUSING SECTOR

It appears that, after passing through a period of severe territorial insecurity, war-related dislocations, and economic traumas, Croatia has arrived in 1996 at a period of relative economic stability. Since 1991, it has made much progress towards the changes that all formerly socialist countries will have to make to create democratic, market-based economies. However, the circumstances of the period placed extraordinary stresses on the economic and political systems and thus, in certain ways, Croatia has further to proceed than the most advanced of the transition economies. (See Annex A for a brief overview of relevant economic conditions.)

On the other hand, Croatia is fortunate to have had greater experience in the past with decentralized economic relations. This turns out to be of particular benefit in the housing sector, both with respect to the presence of a tradition of private housing ownership (as opposed to a dominant state role) and private rentals and the existence of banks competing to make mortgage loans.

Although the potential for further severe territorial and economic dislocations has not been eliminated, the presumption of this report is that the current stability will persist.

Housing Consumption. The current housing circumstance of most of the population, aside from refugees and displaced persons, appears to be similar to, or better than, other Central and Eastern European (CEE) countries. This reflects what appears to have been higher income levels achieved in the pre-reform periods.

The average urban unit in 1991 was 68 square meters, comparable to other CEE countries (but about one-third less than in Western Europe and less than half of US norms), and had risen by 25 percent since 1971. The average urban household enjoyed 22 square meters per person, slightly above the CEE average of 20 square meters per person, but substantially below the Western European average of 32 square meters per person. New units averaged over 80 square meters in size. [2]

The completion of new units averaged about 30,000 annually between 1965 and 1981 (over 2 percent per year of the housing stock) at the time of most rapid urbanization and high remittances from expatriate workers and then drifted down to two-thirds of those levels before collapsing in 1991-94. In the face of very low population growth of 0.4 percent since 1971 and a slowdown in urbanization, production seems to have been more than sufficient to alleviate any true chronic shortage of housing that may have existed as of 1991. (As noted in Annex B, the 1991 Census shows little evidence of doubling-up of generations.) There is no statistical evidence in the housing market that the collapse of production since 1991 has created a shortage of housing.

Although difficult to quantify, the former social housing stock appears to be of better quality and better maintained than similar types of housing in other CEE countries. This may reflect a generally higher level of prosperity in Croatia over the last several decades and a more flexible and decentralized design and construction process carried out at the enterprise level.

Housing Ownership. Even before privatization, about 76 percent of the population occupied a housing unit that they owned. This was mostly because of the sizable rural population which has always been largely comprised of owner-occupants.[3] Even in urban areas, though, there was a high degree of owner-occupancy, primarily through self-built family houses (frequently not legally formulated) or in units owned prior to socialism or multi-family units that people had acquired with assistance from their employer or through cooperatives. Only in the largest cities or heavily industrial towns did either the state or socially-owned enterprises have a major role in housing.

Since 1992, there has been an effort to privatize most of the socially owned housing. It appears that this process has been substantially more successful than in other CEE countries, in two ways. The prices asked, either in the form of lump sum payment or installments, are higher than usual, thus reducing the regressive distributional effects usually associated with practically gifting the housing to the current tenants.[4] Second, it was made clear that the terms of offering would get worse, not better, over time, rents would rise, and that all housing rights would be extinguished upon the death of the current possessor. These

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Republic of Croatia Statistical Yearbook, 1995.

The share of the population classified to be in urban areas is 54 percent. However, the definition of "urban" is a settlement of more than 2000 people. In more normal parlance, about 38 percent lived in towns of more than 50,000 people. It is within these areas that nearly all of the socially owned housing was located and where there was a reliance on socially owned housing.

The local governments are splitting the proceeds with the central government. Some of the local governments are using these funds to build additional units.

considerations have prompted nearly all of those units eligible for sale to be privatized. Older units that had been nationalized after WWII are only now becoming subject to privatization.

As of October 1996, 280,000 of the 393,000 units that were not privately owned have been sold. Many of the remainder were not yet subject to sale for a variety of reasons, but will become so soon. Thus, the Ministry of Spatial Planning, Construction, and Housing considers that for the near future the official owner-occupancy rate will be about 95 percent of the housing stock.

This mass privatization of socially owned housing will have a major effect on the efficiency of utilization of the housing stock. With ownership clearly established and a broader market for apartments developing, more people underutilizing their housing space, and perhaps desiring more income such as meager pensions, will sell or rent that space to those seeking space. In other transition economies, significant benefits have derived from such reallocations.

Several sources have noted the existence of a private rental market, although this is not quantified in any published data and thus is not reflected in the measured homeownership rate.[5] It had occurred in the past and in all forms of housing, including family houses which were subdivided and in privately and socially owned flats. In most cases, apparently, they are leased out without any legal documentation.

The existence of a private rental market may reflect the fact that the former system tolerated such private economic initiative better than in most other CEE countries. There appears to have been a social acceptance of individuals acting as landlords. Moreover, there is confidence that tenants will not abuse their position (i.e., they pay their rent and vacate as requested despite the large costs and difficulties landlords would face to evict a tenant). With the increase in homeownership rates due to privatization, these factors suggest a future expansion in the private, small-scale rental market.

Costs. It is a commonly noted problem throughout the CEE that housing is costly relative to incomes. The problem is apparently due to (1) most material inputs being tradeable goods or having a high content of tradeable goods and thus are internationally priced,[6] (2) relatively inefficient modes of production and regulation, (3) high expectations of housing consumption due to past underpricing, and (4) low income levels. The typical ratio between a household's after-tax annual income and the price of a housing unit they want to buy is 5-6, in contrast to 3-5 in Western Europe and 2.5 in the United States (although the last refers to

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The Central Bureau of Statistics suppresses any data they collect on this. One estimate made prior to the breakup of Yugoslavia was that 5 percent of all households rented from private parties. In Zagreb currently, the major classified advertising paper lists more than 100 units for rent by individuals to Croatians and also a dozen ads by real estate agencies for rental units. Anecdotal evidence is that private rentals were not uncommon even 20 years ago.

Non-tradeable goods tend to reflect the lower wages within a country. But tradeable goods, such as steel bars, are similarly priced across countries. If a house were built totally out of tradeable goods, then the ratio of house price to income across countries would be determined entirely by the variation in incomes.

gross income).[7] Our research, reported in Annex B, confirms that housing in Croatia is no more or less expensive than in other CEE countries, relative to incomes.

This similarity of housing costs across the region does not obviate the fact that those costs are very high. In many Western European countries, the high cost of houses leads people to rent until they have saved up the needed down payment; often they cannot afford it until they reach their late thirties. In other CEE countries, government subsidies are a significant source of assistance. In the absence of subsidies and sources of large savings (e.g., remittances, inheritances), younger Croatians may have to rent more often or stay with their parents longer before achieving homeownership.

HOUSING FINANCE

All commentary about housing finance in Croatia should be prefaced by a basic distinction between Croatians living in villages and towns less than 50,000 people (about 60 percent) and those living in the larger cities (40 percent). Those in the countryside have continued up to the present to acquire their housing primarily through the traditional method of either inheritance or self-construction, usually without formal financing. Self-financing sources include savings, receipts from sale of land, and foreign remittances, as well as construction labor. While rural households may take advantage of any expansion of bank lending for housing in the future, this large part of the population is not experiencing a major change in the way they acquire housing.

Prior to 1991. For those living in or moving to a larger city (8 with over 50,000 population), acquiring housing prior to 1991 could be divided into those following the same manner as in the countryside, including inheritance and self-construction, and those being provided a unit by their employer (plus a variety of exceptions). Essentially, it was a matter between the employer and the employee as to whether the employee would ever be given a unit and what kind of unit.[8] The state took no direct responsibility for the housing of the citizens, in sharp contrast with the practices in other CEE countries.

In theory, employers financed the provision of housing out of funds raised through mandatory employee contributions to a housing fund. In practice, the more profitable employers also contributed additional funds directly to provide more employees this fringe

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This ratio is often quoted as much higher because reference is made to the cost of new construction and the average wage (of one worker). The average household does not buy a new house nor even the average house. Average home buyer households have two wages, usually above average incomes and are buying an existing house. The more relevant ratio is between the household income of the average young married couple and the price of the house they are trying to buy. In addition, imputed income from families owning their homes free and clear or young adults living at home for free, which is not uncommon across CEE, is often not included in the calculation.

Of course, there was a certain amount of self-selection. Those who inherited a unit or began to self-build a unit rather than wait were excluded from eventual granting of an employer-owned unit.

benefit.[9] This distinction was important, because the basic wage tax of 3 percent did not fund many units, but employers in the "non-productive" sectors (government, education, research) had no "profits" to add to their housing funds. Thus, certain groups, such as teachers, could not access housing easily.

The employer did not generally build units directly, but bought them from large projects developed by large construction enterprises. Research and anecdotal evidence has shown that employers bestowed this benefit as a form of non-wage income to their more "valuable" personnel, i.e., who might, in a market economy, have earned higher incomes. Thus, it was much more common in the managerial or technical categories than among unskilled workers. Of course, Party membership, connections, and other considerations played a major role as well.

The role of this method of financing housing can be seen in the data for the 6 largest cities. As of 1981, 46 percent of the housing units in these cities were "socially owned". In the large industrial center of Rijeka, the share was 60 percent. The important implication of this is that, for many, if not most, of the white-collar urban workers, the route to housing did not require substantial saving (although a payment of 5-15 percent of the cost was usually asked, but could be borrowed) nor dealing with a long-term mortgage. It is this socioeconomic group for whom the economic reforms have changed the housing acquisition process entirely.

Today. This portion of the public, accustomed to obtaining housing in this way, and the banking sector are grappling with meeting the on-going need for housing finance, now that the enterprises no longer operate any central housing fund. In addition, the recent economic and security difficulties, which have undercut the ability to save, as well as the secular decline in remittances from Croatians working abroad, have probably substantially reduced the abilities of even those who would have self-built housing or acquired existing units to achieve these goals.

As is discussed in Annex C, most banks surveyed expressed interest in lending for housing, but only a few have been able to venture very far into it, because of the longer term of such loans and low liquidity of the banking sector. We have not been able to establish the totality of housing lending very exactly, but it appears to be on a significant scale, with a rough estimate of DM 150 million in 1996 (but really only DM 100 million net of deposits)[10]. This would put the DM amount on a scale per capita similar to lending for housing in Hungary, but leave

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It was not possible to find any source for the detailed specifics of how this system worked and how many units were financed in what manner. Nor was there any statistical information on the amount or terms of loans that were apparently made by banks and employers for various housing purposes prior to 1991.

At the time of writing, 1 USD equaled approximately 1.5 DM.

it at only about one-fourth amount in terms of number of loans per capita.[11] However, the Central Bank data show that banks are steadily raising their lending to households for all purposes relative to lending to enterprises.

Clearly, though, the current amount of lending is less than the full demand, at least under the currents terms and conditions. All banks but Zagrebacka Banka (ZB) report that they have to turn away many would-be borrowers. ZB states that they meet the demand by all who meet their rigorous criteria, but there are many complaints that the bank discourages applications in a number of ways and it is clear that ZB sets a specific limit on its lending for housing. Moreover, ZB seems to offer somewhat better terms than the other lenders, so the fact that there remains excess demand at the other lenders suggests that many are not able to access a loan at ZB.

ZB is the dominant lender, apparently a reflection of its large size to begin with, more rapid return to health than the other banks, and ambitions to expand lending to the private sector. The other major lenders are Privredna Banka Zagreb and Splitska Banka. It appears that the other large but ailing banks will seek to expand their lending for housing as their resources permit.

Why are the banks so interested in lending for housing? There are at least four reasons.

(1) Housing looks like a much safer bet than lending to most enterprises. The general credit culture on repayment of loans is relatively good and the legal powers for loan recovery for mortgages have just been further strengthened.

(2) The main source of funds to banks is household time and savings deposits and housing loans are a major attraction for potential retail customers.

(3) Households are willing to take on the risks of loans indexed to a foreign currency, giving the bank a good outlet for its deposits in foreign currency.

(4) Banks apparently recognize that they can safely lend a share of their portfolio for a term longer than their deposit structure.

The only concern that banks expressed was that they did not have enough of a base of savings and time deposits to extend enough longer-term loans. This is due in part to low savings rates in comparison with other regions of the world, exacerbated by a lack of confidence in the banking system caused by the war and previous bouts of inflation. However,

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The full comparison is difficult for a number of reasons. First, loan amounts are reported by banks gross of the counter-balancing deposit made by the borrower. For housing purchase or construction, that deposit is one-third, so the net loan is only two-thirds of the stated loan. The average size of a loan is about 4 times larger in Croatia than Hungary also, because of twice higher incomes and costs (stated in dollars), lower inflation, and more liberal underwriting criteria. See Annex C.

it is also a limitation in any bank-oriented housing finance system, one which some kind of access to bond financing could overcome.

The harder question to understand is why households want so badly to borrow. The fact is that credit throughout the economy is very tight and expensive, and housing loans are also. The effective interest rate on a loan indexed to the DM with a stated rate of 9 percent starts around 13 percent the first year (it depends on the rate on the off-setting deposit) and rises thereafter as principal repayments reduce the net effective loan, while the bank continues to earn a large spread on the deposit.[12] The overall average rate, assuming the remaining loan is prepaid when it equals the amount in the deposit, is about 15 percent per year.

In an economy with an inflation rate of less than 5 percent, and the borrower bearing the cost of devaluation relative to the DM, that is a very expensive loan. (It is unlikely that most households understand the effective cost, particularly since it was not clear that the bankers we spoke to did themselves. However, it should be noted that the stated rate on most short-term commercial loans is 20-25 percent, with an effective rate after fees of 30 percent annually. So the banks are granting housing loans on favorable terms, presumably reflecting lower management costs and risks. Moreover, the banks have been generous in the ratio of loan to income that they are permitting (perhaps unknowingly).

Not surprisingly, those getting loans are the relatively upper income households, evident in an average loan size of about 65,000 DM which requires a monthly household income of almost 5000 kunas.[13] Official statistics indicate that 20 percent of all employees in Zagreb are paid over 2500 kunas in 1995, suggesting that perhaps 10 percent of households have two-worker incomes around 5000 kunas. In addition, there are self-employed who are not reflected in these data.

The demand for the loans seems to reflect a severe shortage of alternative methods of gathering the resources for acquiring or renovating housing. This seems to be confirmed by the common observation that the hardest part of getting a loan is gathering the off-setting deposit. Households seem to borrow the absolute maximum amount possible, presumably reflecting an inability to gather from other sources the funds needed.

Of course, this is the same view as in the United States and other countries with well-developed credit systems. But in most developing countries, most CEE countries and even in Croatia to some extent in the past, people would pool enough from all sources to pay cash for a house or at least the self-construction of a house. Presumably, many urban households are compensating for the disappearance of the employer-sponsored housing process by relying on credit. But under the old system, the most they had to come up with in cash was 15

As explained in Annex C, banks in Croatia make loans as a multiple of a deposit held with them. For housing loans, the multiple is three. Effectively, the borrower has to deposit one-third of the loan in a low-rate account for the duration of the loan.

The exchange rates as of November 1996 are 1 DM = 3.5 kuna and 1 USD = 5.25 kuna.

percent. Today, the minimum is 33 percent and will be more if the income is not high enough to qualify for a loan for the other two-thirds of the cost of a house.

WHAT IS THE PROBLEM?

The perceived problem is that many younger people, basically between 25-40 and among the urban skilled population, have not achieved a long-term housing solution and do not feel they have a road map to their goal. Such a situation is a result of expectations based on past experience that clash with current realities. Some of the problem can be traced back to ten years or more of economic difficulty in general. But the disappearance of the former system of socially owned housing and the severe strain on household budgets of the last five years are the primary culprits. The next cohort of households is having to rely on an unsubsidized market-based solution and is poorly prepared to do so.

That much of the situation would be a problem no matter what the condition of the housing finance sector. But the problem is significantly worsened by the very high cost of credit and the great difficulty obtaining it. This situation, though, appears to reflect a general lack of credit, especially long-term credit, in the economy. This part of the situation appears to be subject to eventual resolution only in the normal course of economic recovery, as large state-controlled enterprises are privatized and restructured and as confidence in the banking sector increases with economic and political stability. This resolution is steadily appearing, but will probably take ten years or more to fully conclude. In addition, the pressure of unmet expectations may persist longer, because even reasonable access to market-rate loans may appear inferior to the earlier situation of socially owned housing.

TECHNICAL ASSISTANCE

Elsewhere in the CEE. It is useful to consider first the TA provided in some other CEE countries in housing finance.

In Hungary, TA on housing finance has been focused on (1) encouraging entry by other banks into the market (not because there is not "enough" lending, but there is no competition), and provides "nuts and bolts" TA to develop mortgage lending capacity in the additional banks; (2) both general and operational TA to the monopoly lender on introducing a more affordable mortgage design; (3) policy advice to the Government designed to encourage reduction and rationalization of the (formerly) large subsidies channeled through housing finance and to keep it from veering off into wasteful new subsidies or special lending projects; and (4) continuing support, such as an up-coming loan recovery conference, as to how lenders and government can upgrade the prospects for housing finance.

In Slovakia, housing finance specifically has benefitted from study tours of U.S. practices and mid-level policy advice. Most TA has focused on issues other than housing finance, including (1) creation of a housing allowance scheme that would facilitate the rationalization of rents in social housing, of which there remains a lot despite privatization, and (2) development of the legal and practical aspects of condominium ownership and governance.

In Poland, there has been much effort in the area of housing finance, primarily to bring in additional lenders and to upgrade the mortgage instrument and practices in order to cope better with persistent high inflation. However, the Polish public has largely avoided borrowing and instead adapted to paying cash for flats.

For Croatia. It is to Croatia's credit that most of these efforts do not apply to its housing finance situation. It has a number of banks interested in lending for housing (on the other hand, some of the banks are not as rehabilitated and commercialized as elsewhere yet). It does not suffer from the kind of moderately high inflation that merits a new mortgage design. The banks have already protected themselves from the reappearance of high inflation by the use of DM-denominated loans. Most importantly, it has not recently indulged in large central government subsidies to housing (except for reconstruction).

On the other hand, the Croatian government is being subjected to the same political forces that have been seen elsewhere to do "something" about housing. There are reasonable arguments that the government should subsidize the home purchase of young households. The major one is that fairness requires some transition between the old system whereby (for many) a housing unit (or "loan") was, in most cases, essentially given outright and the new system of having to accumulate at least one-third of the cost and then borrow the rest at a high interest rate. (The argument against such subsidies is that there are many competing priorities for funds.)

In Slovakia, those forces created a large government housing fund from which USAID is now actively attempting to minimize the damages, both to the budget and the evolution of the market. Both the Czech and Slovak Republics have implemented systems of contract savings that have become much more expensive to subsidize than expected. In late 1994, Hungary introduced a huge subsidy for new construction of houses that produced a building boom (mostly in villages) but boosted the deficit by 1 percent of GDP and was ended less than 6 months later.

Thus, it may be desirable to offer TA designed to encourage the design of any subsidies to be limited and targeted, preferably in the form of down payment assistance to just those not owning a housing unit. Alternatively, the assistance can be provided by a matching grant channeled through a contract savings program that is operated by ordinary commercial banks. There is no need to set up a new set of institutions that are dependent entirely on continuing such subsidies indefinitely, such as with a contract savings scheme.

A second area of useful Technical Assistance would be in the creation of a bond-type funding channel for mortgages. As the mortgage banks in Germany proved over 150 years ago, mortgages can be the very best collateral for bond finance in an economy, short of the government credit. This has been the premise of several different systems used in other countries to provide liquidity or refinance to banks making housing loans. It is now being adopted in several developing countries.[14]

There are several benefits from creating such a system. The banks are able to expand their lending in this safe and popular sector. Smaller banks are able to expand their activities without expensive competition for deposits in an environment where the large banks owned by state enterprise have a big advantage. The capital markets themselves benefit from the frequent issuances of this high quality debt.

Croatia is relatively well-posed to explore this option. It has enacted legislation that gives investors a strong basis for expecting that mortgage collateral will preserve the value of the bonds. It has established the basis for indexing the bonds to the DM or even issuing bonds in DM, thereby drawing in foreign capital. The major remaining risk is the larger one of devastation of both the banking system and the housing stock by war-related activity.

RECOMMENDATIONS

Recommendation 1: USAID/Zagreb should attempt to expand the policy dialogue in the area of subsidies and housing finance. Short-term TA should be introduced when possible and appropriate.

The Government appears to be considering some ideas for subsidies to young home buyers, including the Austrian contract savings model that has proven so costly to the Czech and Slovak Republics. That model usually requires large government subsidies to be viable, and commits them over a long period of time, with housing benefits often not realized until several years in the future, when a borrower decides to take and can finally get a loan. Although offering subsidies should not be endorsed explicitly, neither should it be condemned and TA should be used to try to keep subsidies as effective and targeted (and thus small) as possible and to encourage an open policy dialogue. This will not be simple, since there is no clear allocation of policy responsibilities in this area within the Government.

Recommendation 2: USAID/Zagreb should encourage creation of a mortgage-related bond mechanism, possibly in the form of a liquidity or refinance facility.

Such a facility would allow the smaller, private banks to lend more and force the improvement of financing options through competition. Mortgage-backed securities might even be able to attract foreign capital. The first step would be TA directed to the banks and the Ministry of Finance to help prepare a range of options in this regard, encompassing experience in other countries and the special circumstances of the capital and mortgage markets in Croatia. A second step could be to assist in the initial implementation of a system, although this would be much more expensive and may not be necessary, given the relative sophistication of the domestic financial sector. In any event, the consequences of such a

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Such a system would not be based on the sale or securitization of the mortgages themselves. Such a system, similar to that of Fannie Mae in the U.S., is far more complex and risky than needed.

system should be thoroughly explored with the counterparts and it should be clearly communicated that such a system should not create a subsidized financial circuit which would compete unfairly with other aspects of the financial sector.

RECOMMENDED TECHNICAL ASSISTANCE ACTION PLAN

Housing Policy Dialogue

Results: Rational subsidy policies (other CEE countries have adopted wasteful subsidies) and other interventions

Clients: Ministry of Physical Planning, Construction and Housing; Ministry of Finance; Ministry of Social Welfare; Parliament; Selected Cities and Banks

LOE: 3 person months expat STTA

Time Frame: 2 years

Outputs: Policy Seminars, ad hoc analyses and on-site TA, housing policy “working group”

Financial Sector Innovation; Mortgage-Backed Bonds

Results: Increased mortgage lending, longer maturities, more competition (especially smaller private banks)

Clients: Ministry of Finance, banks, National Bank of Croatia, Ministry of Physical Planning, Construction, and Housing

LOE: 5-10 person months, depending on abilities of local TA to implement the program

Time Frame: 3 years

Outputs: Mechanism for issuing mortgage-backed bonds (Federal Home Loan Bank or German mortgage bank model, not Fannie Mae)

ANNEX A
ECONOMIC CONDITIONS RELEVANT TO HOUSING FINANCE

Housing finance systems are an integral part of a country's financial system and a reflection of how the economy is organized. Thus, it is useful to briefly reflect on the past and current economic situation.

REAL INCOMES

The real incomes of Croatians have been buffeted by both the expenses associated with the recent military events and by the collapse of the previous patterns of economic trade. As in other CEE countries, the economic restructuring was reflected in a sharp decline in real incomes of ordinary people. But Croatia and the rest of the former Yugoslavia had a slightly different experience than some of the other countries, because of their previous experience going into this recession.

Yugoslavia had seen periods of marked prosperity in the past, especially due to the rise in Western tourism, emigration of a million workers to Europe as "guest workers" and the availability of extensive credits to the government. This prosperity had become something of a distant memory through the decade of the 1980s, and accelerating inflation, enterprise losses, and rising unemployment had become the norm. However, there was a small burst in consumer expenditures in 1990 just before independence, associated with the Yugoslav Federation government taking decisive action to counteract this economic slide and a sudden rise in the foreign exchange value of the dinar. Thus, the recent decline since then of about 30 percent in real GDP may seem even worse to the average citizen.

The Economist magazine estimates that, adjusted for the relative cost of living, GDP per capita is lower in Croatia than in Hungary, Poland, and Slovakia. Overall, though, the long-term income level of the Croatian economy (or at least the consumer's disposable income from all sources) appears to have been stronger than that of most of the other transition economies. There is a higher standard of infrastructure, better quality of construction and maintenance of housing, and seemingly a higher real standard of consumer durables consumption.

UNEMPLOYMENT

Unemployment is not a new phenomenon in Croatia, in contrast to most CEE countries. In fact, the unemployment rate had risen rapidly in the late 1980s and actually began to decline after 1991. However, it has drifted up again in 1996 to 12.5 percent. More importantly, it is generally accepted that large enterprises must shed many more employees to achieve sustainability.

INFLATION

The former Yugoslavia was infamous for having a high rate of inflation, and this ill was carried over to the new nation at independence. The root cause of this was the effort by the Central Bank to generate funds to keep the large loss-making enterprises afloat, a well as finance military activities and war damages. Moreover, the entire foreign exchange reserves of the country had been confiscated by Belgrade at the time of independence in 1991.

This situation has important implications for housing finance. First, Croatians have become accustomed to thinking of most important monetary things in German marks (DM), including wages and house prices. Since independence, it appears that loan amounts and loan repayments have also been indexed to the DM. Second, the banking sector steadily lost local currency deposits and eventually all deposits of any kind after the government froze all foreign currency deposits in order to create foreign exchange reserves.

Croatia benefitted from the recovery of tourism inflows after 1991 and from large remittances from emigrated Croatians for the war and reconstruction efforts. However, the most dramatic step was the fixing of the exchange rate and freezing of wages, which restored some confidence in the currency and permitted the banking sector to expand the money supply without printing it. Soon thereafter, a new currency, the kuna, was introduced and has been kept at a nearly stable level with the DM (about 3.5 kuna to a DM). Inflation is expected to be about 3.5 percent in 1996.

ECONOMIC REFORM

Croatia had the advantage of a more liberal economy than most of CEE going into independence, but in some ways the marginal viability of the system (together with the war) seems to have slowed its transformation.[15] Most of the smaller enterprises in the economy have been privatized. This was often accomplished by employee or management buy-out, which limited the infusion of new capital for investment in modernization and the streamlining of labor utilization. However, the largest enterprises, constituting about 50 percent of the economy, remain to be privatized. Meanwhile, the cumulative arrears of these enterprises to the banks steadily rise, sharply limiting the credit resources for housing and other sectors.

Not surprisingly, the government is under great financial pressure to resolve this situation, even at the cost of higher unemployment. It seems to be still too early to determine what compromise of political, social, and economic forces will be found. But observers have noted that, in the longer run, there really are no other palatable alternatives, since continuing reliance on bank credit to cover losses will reignite the inflation and lack of private capital, especially foreign investment, will revert the economy back to the stagnation of the 1980s.

THE FINANCIAL SECTOR

As was noted above, the financial sector has been decimated by years of inflation and various recent shocks. However, it went into independence with one major advantage over those of most other transition economies, namely, there were a number of somewhat autonomous banks operating. Although the banks were generally controlled by shareholders that were socially owned enterprises, they competed to some extent for the public's deposits and had separate identities and professional management.

It appears, that outside of agriculture, the great majority of the economy was operated by socially-owned enterprises, with some kind of employee self-management. As had already become evident in the 1980s, such an ownership structure was ultimately nearly as deadly for the efficient operation of the enterprises as state ownership.

This situation has not saved the banks from being effectively bankrupted by the cumulative losses of the loans to enterprises. This has meant that each bank has had to be rehabilitated through government assistance with the bad loans. But, after rehabilitation, the old banks, along with new private banks, appear to be more amenable to market-type banking activity than banks in other countries which operated solely as conduits to state-owned enterprises of household savings gathered by a monopoly savings bank. In addition, there are multiple entities that have traditions of dealing with households on both the deposit and credit sides. Each region has traditionally had a bank focused on that area. Thus, the household credit and deposit markets have ready-made competitors while other CEE countries struggle to introduce true competition.

Capital markets in Croatia are in an embryonic stage, with some significant activity in equities of privatized companies and only one bond not issued by the central government. The central government is attempting to steadily expand the market reception of its debt issuances, hoping to create a market for medium-term issuances, as well as short-term Treasury securities. Most important, the government is in the process of getting a credit rating which could permit it to issue bonds on the Eurobond market.

INTEREST RATES

As might be expected, interest rates are very high in Croatia. The shortage of funds and the tradition of losses on many loans has made the banks look for large spreads between deposit and lending rates. There is no evidence in discussions with several banks that interest rates are either implicitly or explicitly controlled by the government. The rates on domestic deposits in DM and kuna are probably closely related to those offered on DM deposits by foreign banks accessible in Austria, which are quite low currently. Rates on kuna deposits are somewhat higher, because of the risk of devaluation. Since there is somewhat higher inflation in Croatia than in Germany (4 percent vs. 2 percent), it is reasonable to expect some downward drift in the value of the kuna.

As of July, 1996, the National Bank of Croatia reports that interest rates on deposits of all kinds in kuna averaged about 6 percent, but time and savings deposits averaged 14 percent. However, savings deposits in foreign currency (usually DM) averaged only 6.5 percent, yielding a saver a premium of over 7 percent for taking the risk of devaluation. Despite this premium, there were 7 times as much time and savings deposits in foreign currency than in kuna.[16]

Lending rates for short-term commercial credits are reported as 23-25 percent, whether linked to the DM or not. However, this does not include various recurring fees that apparently raise these rates to 30 percent or higher. The stated rates on longer-term loans are 16.5 percent in kuna and 11 percent if indexed to the DM. However, these loans require significant

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It is not known exactly how the interest rates on deposits related to receipt of a loan are accounted for here. Since these deposits receive a special low rate of interest, there presence could be distorting these figures. However, it appears likely that they are not included.

offsetting deposits by the borrower, substantially raising the effective rate. As is noted in Annex C, the effective rate for a housing loan, with a 9 percent stated rate but with a one-third deposit requirement, is over 15 percent.

Such a rate on a housing loan is quite high, especially since the risk of devaluation is carried by the borrower. It can be contrasted to a rate of 6-8 percent paid by a borrower in DM in Germany. However, it is clearly reasonable given the high rates on competing uses of scarce funds. Moreover, it is notable that the rates on housing loans are substantially lower than on commercial loans. Presumably, the commercial loan rate contains a large risk component, especially for those banks that have been rehabilitated and are not expecting further compensation for losses on loans to enterprises. Housing loans are apparently viewed as having low credit risks (but inconveniently long terms of up to 15 years).

It should be noted that the banking system is currently showing signs of excess liquidity, which has driven interbank lending rates down from 30 percent to 10 percent in the last 6 months, although this has not seemed to significantly affect lending rates for household borrowers yet. It is possible that the general structure of interest rates will decline in the near future. Meanwhile, though, borrowers of all types are facing real interest rates of at least 10 percent (difference between nominal effective rate and inflation), so credit for any purpose is expensive relative to self-financing. ..

ANNEX B
OVERVIEW OF THE HOUSING SECTOR

The housing sector has been thoroughly studied in an earlier report.[17] This overview will not attempt to encompass the wide range of information contained in that report. The goal here is to provide enough of an overview to support the analysis and conclusions of this report.

PRE-REFORM HOUSING SYSTEM

All of the formerly socialist countries in CEE are famous for the role assigned to the state for providing for the housing needs of the population. This was a reflection of the premise that everyone had certain basic needs that they had a right to have met. In practice, though, the state's role only came to bear in the cases of the urban "proletariat," and not for rural villagers who continued to self-build housing from their own resources (except to the extent that agricultural "kombinats" introduced factory style operations).

The pattern was similar initially in the former Yugoslavia. However, with the devolution of more authority to various enterprises of all kinds, including industrial, cultural, educational, and municipal, the responsibility for housing passed from the state to the enterprise. Thus, the resources and allocation mechanisms became more enterprise specific (in other countries, most allocation was by the local government). This introduced more of an opportunity to use housing as an important component of non-wage compensation for employees. It also meant that enterprises not producing "profits" had very limited ability to offer "socially owned" units to their employees.

Urbanization of the country proceeded with housing needs being met by a mix of methods. In the cities with populations over 50,000, construction of socially owned units (on which a small rent was paid by the occupant towards maintenance) was at a level high enough that 45 percent of the housing stock was of this type by 1981. Occupancy of this housing was concentrated among higher-skilled and technical workers and managers. However, other than those working for the most profitable companies, there was no assurance of getting such a unit anytime soon.

The fact that employer provision of housing was not dominant is reflected in data gathered in the 1980s and reported in Gantar and Mandic (1991).[18] For all adults in Yugoslavia, 28 percent were living with relatives, primarily parents (or in-laws). Of those living independently, 38 percent were in self-built housing, 22 percent had inherited a unit, 9 percent had purchased one, and only 26 percent were in socially owned rental housing. Notably, over 5 percent (apparently mostly students and young couples) were in private rentals.

It appears that it was conventional for most employers to make some credit available to those who would self-build. There is almost no reliable information on this practice, except that the loans were apparently at fixed rates and expressed in dinars, and thus were generally effectively grants, given the high rates of inflation. Nothing is known about how substantial this

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"Croatia: Housing Sector Assessment," by Jerry Erbach and Mila Zlatic, Urban Institute/PADCO for USAID, May 1996.

"Social Consequences of Housing Provision," Pavel Gantar and Srna Mandic, in Yugoslavia in Turmoil: After Self-Management by James Simmie and Joze Dekleva, London, 1991.

kind of credit was. However, apparently, a growing part of it was being channeled through housing cooperatives in the 1980s.

Unfortunately, because little could be ascertained about the role of the banks or the employers in financing self-building or purchase of housing, the previous status of such individual (as opposed to communal) housing finance is unclear. What is clear is that the production of socially owned housing began to decline after 1983 and had already shrunk to 40 percent of its previous level by 1990. This probably engendered a growing concern among younger urban households as to how they would acquire housing, a concern predating independence. The collapse of construction of socially owned housing since independence seems to have brought this concern to the forefront.

HOUSING DEMAND AND SUPPLY

The population of Croatia has been roughly constant for over a decade. In fact, since 1953, the average rate of population growth has been less than 0.5 percent. The war-related upheavals since 1991 make reliable numbers impossible, but the net effect of the war and economic dislocations in the region may have been a net decline in population. However, there are clearly a large number of displaced persons and refugees whose housing situation is temporary. Despite the presence of many of these people in Zagreb, no evidence was found in discussions or available data of an overall shortage of housing. It appears that most refugees are being housed in temporary accommodations and are not entering into the market to obtain permanent housing, at least not in Zagreb.

The high levels of housing construction since World War II were due to the rapid urbanization of the work force in the 1960s and 1970s and the upgrading of the rural housing stock (often financed by remittances). The two-thirds decline in construction since 1983 can be ascribed to the deteriorating economic conditions, but it has not seemed to produce any signs of overcrowding or shortages, since demographically driven demand for additional housing has also fallen over the period.

Field observation and discussions suggest that currently most construction in urban areas is either self-help construction of family houses or market-oriented construction of large multi-family buildings by the larger construction companies. There has not yet appeared significant numbers of small-scale builders of 4-20 flat buildings, although anecdotal evidence indicates that there is high demand for these types of structures. This may be because of the difficulty of obtaining finance or because of difficulties of obtaining suitable land and permissions.

A notable feature of the housing supply sector is the ability of individuals to build without proper approvals and then get the approvals later, without having to meet many of the regulatory requirements. There is no attempt to police such activity, aside from areas of danger or serious conflict with planned alternative uses. Since units will usually be approved retroactively, there is a large incentive for self-builders to skip the delay and red-tape of seeking formal approvals. This gives self-building a significant advantage over purchase from a developer and ensures a safety-valve for unmet demand. It also means that the reported data on construction may not be accurate, since such units are not reported either during construction or upon regularization.

CROWDING

There is no data available on the long-term trend in doubling up of related or unrelated households. But the data for 1991, the only year available, indicates a relatively benign situation in this regard. There were 879,000 households in urban areas (towns over 2000 in population), of which 18 percent included only one person. Only 5 percent included more than one family, in other words, where there was a married child living with parents. Some of these may not reflect overcrowding, but simply a planned multi-generation arrangement of an expanded family house. (The fact that 11 percent of households in rural areas, where housing is relatively easy to self-construct, live in such multi-generation households supports this view.)

Unfortunately, there is no data on more recent trends in this regard. It is commonly stated that more young adults and couples are living with parents (or even leaving the country) because of the difficulty of buying a flat. This is probably the case, but not because of an increase in prices or rents for housing or a shortage of units, but because of higher unemployment, lower real incomes, and the end of units being paid for by employers.

HOUSING CONSUMPTION

The most recent data, in the 1991 Census, shows a steady expansion in the average interior space of housing units up to a level higher than in most other CEE countries. From 54 square meters in 1971, the average size of an urban unit grew to 68 square meters in 1991 and the average space per person was up 44 per cent to 22 square meters. This was above the average space per person in the rest of Eastern Europe of 20 quare meters. On the other hand, data indicates that Western European countries average 32 square meters per person.

HOUSING AFFORDABILITY

The fact that most Croatians are relatively well housed can be taken as evidence that housing is reasonably affordable. However, it is arguable that the present situation arose from the presence of deep subsidies for housing for those receiving socially owned flats and the good fortune of periods of major inflows of remittances. Such assistance in the past does not relieve the burden faced by the new generation in obtaining housing.

The usual measure of housing affordability is to compare house prices with household incomes. By this measure, Croatia ranks about the same as other CEE countries. The average after-tax wage of salaried workers in Zagreb in 1996 is about 2300 kuna, or 650 DM, per month. A household with two average workers would earn 1300 DM per month or 15,600 DM per year. Such an average household would find that the average flat (not family house) of 50 square meters would cost about 100,000 DM or 6.4 times annual income. This can be compared with a ratio of 6.5 for a similar household (earning about 50,000 HUF a month) and a similar flat (costing about 4 million HUF) in Budapest. Similar conditions apply in Slovakia.

However, housing is more expensive in the CEE countries than in most of Western Europe and North America. The average ratio of price to income in Germany appears to be about 4-5, in France about 3-4 and only about 2.5 in the U.S.

This method of assessing affordability actually underestimates the differences between countries. This is because households in areas with less expensive housing generally buy more housing. Comparisons based on the ratio of the cost per square meter to annual income show an even greater divergence. German homes cost about 4,000 DM per square meter, in contrast to 1,500-2,000 DM per square meter in Croatia, but German incomes are about 6 times as high. Thus, relative to incomes, Croatian households face housing costs that are almost 3 times as high. They react by buying 30-50 percent less housing space, but still end up with a higher housing cost burden.

The important point here is that the common perception that housing is very expensive is correct, but is typical of the region and of transition economies. To at least some extent, these countries have historically offered housing of too high a standard, given the real costs relative to incomes. It can not be taken for granted that the next generation will be able to attain the same standards, at least not without significant sacrifice.

ANNEX C
OVERVIEW OF THE HOUSING FINANCE SECTOR

I. Pre-Reform Financing Activities

In the former Yugoslavia housing construction, purchase, and renovation was financed primarily by employer-sponsored direct funding and personal cash savings (including foreign remittances). In rough outline, it appears that, aside from those with access to foreign remittances, most urban housing was built by large construction companies principally for sale to other enterprises or local governments/institutions for “rent” to their employees. Single family houses were also built in substantial numbers in both formal and informal developments, usually over a multi-year period (see Annex B).

There were a number of ways that housing was allocated to employees, including the granting of “housing rights” which in effect gave the tenant the right to occupy a specific apartment (most common), gift of units, or assistance in the purchase of units. When the housing rights were granted, a 5-15 percent payment was required, followed by continuing “rent” payments for maintenance. The deposit amount could be borrowed or possibly be given by the employer. When units were purchased, they were usually bought on an installment basis or bought with a 90 percent loan from the employer's housing fund. Enterprises could also award grants to employees so that the deposit required to obtain a bank loan could be more easily accumulated. No one method was used to finance the purchase of housing; practices varied according to the enterprise or local government/institution and how much funding it had available for housing.

Discussions with banks indicate that they did engage in lending to individuals for housing, but at a low level in relation to the housing market as a whole, and somewhat reluctantly. It does not appear that availability of credit was constrained by the lack of funding that characterizes the current situation. The reluctance was due to the high interest rate risk involved in long-term housing loans in a very inflationary economy (loans were not indexed to the DM), along with the impracticality of foreclosure should all other means of recovery fail.

Loan recovery in the pre-transition period seems to have been based on the use of a variety of tools, most importantly the guaranteed income stream from the borrower and guarantors should the loan become delinquent or default. Foreclosure was legally possible but rarely used. Even when foreclosure was pursued, eviction of the occupant was complicated by a social welfare clause in the relevant law which prohibited or significantly delayed eviction for a broad array of social groups.

II. Structure of Banking Sector

The banking sector in Croatia today is relatively well-placed to provide housing finance. Unlike other CEE countries, Croatia both before and during the transition has benefitted from the presence of multiple banks as players in the system. Although one bank, Zagrebačka Banka, is clearly the leader in terms of loan volume and savings deposits, several other banks are involved in housing lending and even more in consumer lending. Compared to lending to loss-making enterprises, retail banking is currently viewed as a lucrative and relatively safe market for bank expansion. This adds an important element of competition to the banking sector, which eventually should drive interest rates down and simply loan requirements, especially as new private sector banks enter the market.

This situation reflects the fact that the former Yugoslavia was a confederation of disparate states and that each state was composed of fairly diverse regions, usually with their own banks. Under Yugoslavia's "market socialism", financial power was partially decentralized to the enterprises, who in turn were the major shareholders of the banks. The result is today that the banking sector has a number of large competitors. In addition, regulators have permitted a large number of new banks to be established and even some foreign banks have entered recently.

Counterbalancing this advantage have been several major traumas to the banking sector. The war had a negative effect, particularly devastating for some banks, on the savings deposit base. In Slavonia, which was the scene of some of the heaviest fighting in the war, residents understandably withdrew their deposits as they either fled the area or to tried maintain basic consumption levels as economic activity dropped. Slavonska Banka, the major bank in that region, lost all but 5 percent of its deposits and is only now building its deposit base back up to pre-war levels.

Another major drain on the banks' funding has been continued loss-making loans to enterprises, which for the most part still need to undergo significant restructuring. The banks are caught in an untenable position because, although cutting off credit to the enterprises will free up funding for more profitable activities, the economic effects of the failure of major enterprises could devastate the local economy in which they operate.

A third problem until 1994 was the debasement of the currency, as the central bank expanded the money supply to support enterprises and the war effort. The public reacted by keeping their deposits in the banks to the bare minimum. A fourth blow to the system cam in 1991, when Croatia broke away from the Yugoslav federation. The Central Bank in Belgrade possessed all of the federation's hard currency reserves. In order to finance any trade, the new central bank, the National Bank of Croatia, froze all of the foreign currency deposits in the banks. Thus, citizens who had shunned local currency deposits for foreign currency deposits now lost faith in the banking sector entirely as a repository of funds.

Since 1994, the government has undertaken great efforts to restore faith in the banking sector and the currency, but deposit levels will only gradually return to what they should be in such a sophisticated economy. This is important because the major banks currently making housing loans fund them primarily through time and savings deposits from citizens. This situation, combined with continued loans to large enterprises, has led the financial sector to ration credit for housing. Since there is no liquidity or mortgage bond facility in the market, other banks, particularly new private banks, face the task of attracting substantial amounts of savings deposits before they can begin to make long-term housing loans.

One important outcome of this history is that all housing loans are pegged to the Deutsche Mark. This a result of high inflation not only since independence but also in the previous regime, when it was common to quote prices of homes and rents in DMs. However, all transactions are carried out in Kuna. Each monthly payment is calculated according to the average DM/Kuna exchange rate for the previous month. The effect is to push all foreign exchange risk onto the borrower (although the risk that the borrower may not be able to exchange currencies is borne by the banks), who must adjust monthly mortgage payments to the pressures of foreign exchange markets.

Although the Croatian Kuna has been relatively stable since its introduction in 1994, there is still a perceived risk of deterioration due to recent history and the current structure of the economy, which to many foreign analysts appears shaky. The impact on the development of the domestic mortgage market is negative because it undermines the stability of the Kuna and will retard the growth of a potential domestic mortgage bond market which would depend on the availability of long-term domestic funds. Given the relative stability of the Kuna since its introduction, however, some banks are developing or considering loan instruments denominated purely in Kuna.

III. Present Financing Activities

As of November, 1996, three of the top five banks in Croatia are known to be making housing loans (Privredna Banka, Zagrebačka Banka, and Splitska Banka). The other two banks (Slavonska Banka and Riječka Banka) generally plan to restart lending for housing as soon as their liquidity position permits since they view housing loans as relatively safe and profitable. This view appears to be shared by new private sector banks entering the market. Discussions indicate that Gradska Banka, an entrepreneurial 4 year-old bank based in Osijek, is already engaged in consumer lending and foresees longer-term housing loans as an important part of its business plan. It has plans to expand to a national scale.

Of the three main banks making housing loans, Zagrebačka Banka possesses the largest market share, probably around three-fourths of the total housing finance market. Projected housing loans for 1996 are estimated for ZB at approximately 110 million DM. The nearest competitor, PBZ, projects only about 10 percent of those numbers or 10.6 million DM at its Zagreb office; national estimates for PBZ should be doubled to an estimated 21 million DM. Assuming that Splitska Banka lends about the same amount as PBZ in Zagreb, the total volume of housing loans for 1996 can be roughly estimated at between 140 and 150 million DM.[19]

However, this is the reported gross volume of lending. It appears that all housing-related lending is based on the 3:1 ratio, so the net lending would be about DM 100 million or USD 66 million. Compared to a volume of USD 150 million in 1995 in Hungary, a country of twice as many people, this seems like an equal amount per capita. However, incomes and prices in USD are twice as high in Croatia as in Hungary, thus a loan volume such as this is effectively only half as much. Moreover, because of the lower interest rates and looser

ZB's reported housing loan volume dropped from 172 mln to 110 mln from 1995 to 1996 but that this seems caused by a reclassification of most lending in the home improvement category into "no-purpose" loans. Home purchase lending will probably increase slightly in 1996.

underwriting rules in Croatia, the average loan is actually 4 times as large (in USD). Thus, the number of loans actually made per capita is only about one-fourth that in Hungary (an exact comparison is difficult because of different categorizations), where lending is very muted by high interest rates (but no rationing occurs).

Funding is very limited and is rationed to consumers by banks through high interest rates and difficult approval procedures. The common view is that only a small portion (estimated at ten percent by several banks) of the demand for housing finance is met, and that over half of those who successfully meet the banks' cautious criteria for loans must be turned away for lack of funds. Rationing is evidenced by lines which appear outside of banks' housing credit windows whenever an allocation of funds for housing loans is made.

General terms for housing loans can be described as follows: (1) the loan amount is in Kuna, expressed as DMs at the current exchange rate; (2) interest rates are fixed in DMS and the payments are level in terms of DMS; and (3) households take all the risks of a major revaluation of the real exchange rate, but not the risk of difficulty of converting to foreign exchange.

Housing loans are available for a variety of purposes such as housing purchase, reconstruction, improvement, and renovation. At the largest housing lender, Zagrebačka Banka, home purchase loans comprising 42 percent of the bank's 1995 housing loan portfolio, averaging approximately $46,000. "Home Improvement" loans are also quite popular, with over 45 percent of the bank's housing portfolio categorized in this way. These loans average about $12,000. It is not clear, however, exactly how "home improvement" is defined and it may include consumer loans for other purposes but secured by property.

Despite the competitive presence of a number of different banks making housing loans, there does not exist any significant amount of differentiation in lending terms across banks, although this should change over time. In comparison to Western Europe or North America, the qualification process for a housing loan in Croatia is quite extensive and relatively complicated, and determining the effect of the true terms somewhat complicated.

Prequalification

As is traditional with European banks, most banks require that the borrower open an account in the bank as a pre-condition for a loan. From the banks' perspective, servicing the client's savings and checking account in addition to the housing loan signifies a closer relationship to the client and additional business. The amount of the loan is then subject to the amount of savings deposited and the length of time the account has been opened. For example, Privredna Banka requires establishment of a savings account for at least three months, and that the amount of savings must equal or exceed ten percent of the loan. As an alternative, the borrower may possess an equal amount of assets in the form of bank shares. A more burdensome requirement is that the borrower obtain three guarantors of repayment. These guarantors must not themselves have a loan outstanding and must promise to undertake repayment of this loan in case of default.

Loan-to-Value Ratio

It appears that virtually all banks involved in housing lending require a compensating balance held at the bank in the form of a low-rate savings account. This is described as a "deposit" or "down payment." However, it appears to serve the function of raising the effective interest rate and perhaps making the balance sheet of the bank look large. The amount is usually one-third of the total loan value. However, Instead of using the down payment to establish equity in the property purchased, as in virtually every other housing finance system across the world, the funds are deposited in the bank and held there. The deposit in effect serves as cash collateral for the bank, but for a larger loan than would otherwise be necessary. Thus, instead of a 67 percent loan-to-value ratio, the bank *on paper* may lend 100 percent of the value of the home.

It should be noted that in terms of the financial security of the loan, the "3:1" system (lending three times the deposit amount) makes no difference to the bank. In other words the bank is really lending only 2/3 of the total amount since it keeps the equivalent of 1/3 in the bank as a deposit. A typical example would be a loan for 100,000 DM. The client would need to amass 33,000 DM in cash to deposit in the bank[20]. The bank then lends 100,000 DM for the purchase of the home. If the client never pays a DM on the loan, and the bank does not foreclose, the bank faces a loss of 67,000 DM, since 33,000 DM are held in the bank. If the bank had lent only 67,000 DM and the client had put 33,000 DM into the home as a down payment, the bank would still face a loss of 67,000 DM.

This peculiar aspect of the Croatian and Yugoslavian banking system is not easy to explain. However, it seems to be the predominant requirement not only for housing loans but also for other consumer and business loans. One possible explanation might be contained in the legal and regulatory system for lending and property ownership. For example it might be a stronger position for the banks to sue for 100,000 DM (using the example above) than for 66,667 DM. Yet other CEE countries with similar levels of borrower protections follow more closely the model of normal housing finance systems in which the down payment is used to establish equity in the property. Another explanation is that the system allows the banks to charge an effective interest higher than the stated rate (see discussion below), which might be regulated somehow (although no evidence of this was found).

It is also possible that the way banks are regulated makes it advantageous for a bank to claim it is lending more than it really is. The system also creates the illusion that the banks are more active than they are in reality; in effect there is a double entry in that banks' deposits increase with the down payment deposit and loan volume increases with a larger loan size. The most simple explanation is that banking practices simply developed this way in this region and over time became accepted as the norm.

Prospective borrowers uniformly complain about the "high deposit" needed to qualify for a loan. It appears that the public does not perceive that the deposit is simply a part of the "down payment" (in U.S. terminology) that they will need for the home purchase. In cases of home improvement loans, however, the deposit requirement truly is an unnecessary burden.

Discussions with banks revealed that some are thinking about reducing the required deposit amount to as low as 10 percent of the total loan amount, and even are considering doing away with it altogether if the financial system continues to stabilize.

Maturities

The maximum loan term for housing purchase is 15 years, and most loans for the purchase of housing are in the ten to fifteen year range, in contrast to up to 25 years in the past. The maturities for home improvement loans are usually shorter than for home purchase, from 5 to 10 years. It is not clear at this point if the maximum term is regulated by law or, presumably, banking custom. A longer term loan would certainly increase the affordability of housing finance, but given the economic and financial instability of the pre- and post-transition system, it may be that both the lender and borrower prefer as short a term as possible.

There is an interesting aspect with regard to the “3:1" system and the maturity of the loan. Apparently it is assumed that the compensating balance held by the bank will be used at some point to pay off the balance of the loan. Let us cite again the previous example. If the 33,333 DM deposit the bank holds (plus interest earned on the deposit, ranging from 1-5 percent) is eventually used to pay off the loan when that amount equals the remaining principle, then a 10 year term loan would actually be paid off after about 7 years. This could be considered advantageous to both the borrower who saves by not paying the higher interest rate on the loan over the remaining three years and to the lender in that it minimizes the term of the loan.

Discussions with the banks on this issue reveals that not much thought has been given to this aspect of the loan. Since Croatian banks’ housing loan portfolios are generally only a few years old, (the old portfolios are more or less paid off or written off) there has not been much practical experience in this area. Nonetheless, the effect could be positive for the housing finance system in that loans paid off early will improve the banks’ liquidity position, thus making more funding available for lending.

Effective Rate

The cost of credit for housing loans does not vary greatly from bank to bank. Generally the stated interest rate is fixed at 9-9.5 percent per year. The interest earned on the deposit ranges from 1- 5 percent per year, but is always stated to be subject to change. This 4-8 percent spread is a substantial source of income for the banks since the down payment remains with the bank for the term of the loan (or somewhat less if the loan is paid off early as described above). Conversely, it represents a high opportunity cost for borrowers, suggesting a strong demand for credit.

Thus, the “3:1" system results in a far higher effective yield for the banks than the stated yield. For example, the effective interest rate on a loan with a stated rate of 9 percent and a return on deposit of 3 percent starts at 12 percent the first year and rises thereafter as principal repayments reduce the net effective loan, while the bank continues to earn a large spread on the deposit. The overall average rate, assuming the remaining loan is prepaid when it equals the amount in the deposit, is 15.3 percent per year. The effective rate is more in line with funds in the financial sector, running about 20-25 percent for riskier short-term credits. But is far more than a German pays for a credit in DM, currently around 7-8 percent. Compared with recent inflation rates, it implies a 10 percent real interest rate.

Borrowing Power

One of the other notable aspects of Croatian lending is the use of a maximum payment-to-income (PTI) ratio of 50 percent. This partly reflects the fact that the net loan is only two-thirds of the gross loan, but it still means that the banks and households are willing to place a fixed claim of 50 percent on monthly income, much higher than elsewhere in CEE, Western Europe and North America.

This situation does not raise affordability substantially (meaning the maximum amount that can be borrowed), because the monthly payment is 50 percent higher than normal, since the stated loan is 50 percent higher than the effective net loan. What does raise affordability is the fact that an interest rate of 9 percent is used to calculate the payment, while the effective yield is actually 15 percent. If a rate of 15 percent were used, the amount that can be borrowed is nearly one-fourth less, and decreases as the term of the loan is lengthened.

The following table illustrates this point. If the banks used standard underwriting procedures and allowed a 50 percent payment to income ratio on the *effective* rate of 15 percent on a 10 year loan, the maximum amount borrowed would be $24,880. Since the *stated* rate of 9 percent is used instead, the borrower can take out a loan for substantially more -- $31,545. With a 15 year loan, the maximum loan is even greater in proportion when the same comparison is made. The third row in each part of the table provides an example of the maximum amount borrowed according to underwriting standards in other countries, that is, with no compensating deposit and a 33 percent payment to income ratio. The amount borrowed would be comparable to the Croatian system if the banks underwrote the loans based on the effective rate instead of the stated rate.

Payment To Income	Loan Interest Rate	Deposit Interest Rate	Household income (DM)	Maximum Loan Size	Loan size (net of 1/3 deposit)
			10 Year Loan		
50%	9%	3%	1200	47,365	31,545
50%	15%	3%	1200	37,700	24,880
33%	15%	None	1200	24,793	24,793
			15 Year Loan		
50%	9%	3%	1200	59,160	39,400
50%	15%	3%	1200	28,935	28,935
33%	15%	None	1200	28,580	28,580

IV. Housing Loan Recovery

Traditionally, there has been a reluctance to foreclose and evict in order to enforce loan recovery. The reasons are similar to other CEE countries in that once a resident obtained housing, it was seen and treated basically as a right, even if it was from the enterprise and not the state per se, and was not taken away for non-payment. On the other hand, the system of low unemployment and few private enterprises ensured good repayment records. All that has changed in the new economic arrangements.

Loan Origination

The primary form of loan security, at least on paper, is the mortgaged property. However, since foreclosing and recovering the property is a lengthy and virtually untested process, and given the difficult social context in which foreclosure and eviction for non-repayment of mortgage loans must operate, banks in Croatia have traditionally employed an array of other tools to minimize credit risk when originating loans.

The borrower is personally liable for the total value of the loan. He/she must generally guarantee to the bank access to employment income in the event of non-payment. In addition, assets placed in Croatian banks above and beyond the loan deposit can be seized in the event of default. One of the most onerous requirements is that the borrower must typically have three guarantors, who cannot be immediate family members. The guarantors must sign what is termed in Croatian a “bianco” (basically a promissory note) which appears to be a legal document pledging to the bank access to employment income up to the total amount of the loan in the event of non-payment of the loan. All guarantors are equally liable for the loan (joint & several liability).

Another requirement is for the bank to employ an accredited appraiser to estimate the value of the property being pledged to ensure that the gross loan size does not exceed the value of the home.

Normal Servicing and Delinquency Management

Detailed discussions with Privredna Banka on servicing and delinquency management indicate a sophisticated system which is presumably typical for other banks making housing and consumer loans. Every client, upon origination of the loan, receives a detailed description of the loan recovery requirements, which vary depending on the purpose and amount of the loan. Clients receive monthly notices to remind them of the amount owed, just as any monthly utility or credit card bill. The idea is to make housing loan payments a regular part of the client’s monthly budgeting exercise. Loan payments are due at the end of the month, with an eight-day grace period. If payment is not received by the 8th of the following month, a reminder is sent to the client, notifying him/her that arrears are charged if the loan is more than 8 days delinquent. Penalties for arrears are set by the National Bank of Croatia at 30 percent per annum on the payment due and serve as an incentive to make payments on time.

After two loan installments become delinquent, notices are sent to the client and the guarantors, and legal action can be taken at that point to cancel the loan. The bank is very careful about canceling the loan since there are other delinquency management measures which can be taken to recover the loan at less cost to the bank. Loan work-outs and negotiations are attempted as the first resort, and by being flexible the bank can often restructure the payments and keep the loan more or less current. Sometimes the client agrees to pay a few installments and the balance of the loan must be recovered in court. The pressure of the guarantors on the client appears to be a very effective way of forcing the repayment of the loan when possible. The bank maximizes delinquency management by knowing its clients well and understanding what techniques will be most effective given the client's individual circumstances. PBZ estimated that over 80 percent of delinquent loans are worked-out in this way before they go to court.

Foreclosure and Execution Procedures

Once all the delinquency management measures have been exhausted, the bank may proceed to recover the loan through the court system. It appears that only a relatively small number of loans actually reach this stage; PBZ and ZB estimate that about 1 percent of their housing loans are in permanent default.[21] A court procedure is also required for the banks to attempt to recover the loan through the guarantors, who have the same legal standing in court as the borrower. In order to initiate the procedures, the bank notarizes and delivers the promissory notes signed by the borrower and guarantors to request payment. The usual process is for the bank to approach only one guarantor at a time to collect the loan, presumably to cut down on legal fees and delays and so that the other guarantors are available if additional action is required.

Discussions with banks in Zagreb have indicated that it is exceedingly rare for foreclosures to even be pursued. The head of the loan recovery department at PBZ noted that in her fifteen years with the department, this year's 5 or 6 foreclosures are the first she can remember. Her comment also indicates, though, that attitudes are beginning to change and that the decision to foreclose is at least being pursued by some of the banks.

Foreclosing on the property pledged is used only as a last resort. A new law on the enforcement of judgements has recently been passed by the government of Croatia, effective in July, 1996, which significantly improves the lenders' position with regard to foreclosure.

Although the old law allowed foreclosure, the enforcement mechanisms were weak. Information gathered to date indicates a typical 4 year period from the time a bank decides to foreclose and when the property can be auctioned off and the loan recovered. First the bank must get legal title to the property, which can take 1-2 years in the courts. Once legal title is obtained, it may take another 1-2 years for the court to order an enforcement of the judgement, i.e. to evict the non-paying tenants. The court actions can last years because after each phase, the tenant can lodge a protest which requires a ruling before proceedings could continue. It is not at all clear that once legal title is obtained that the enforcement judgement will automatically follow. Under the old law it was possible to recover title to the property and sell it to recover the loan, but

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The defaulted loans are likely to be larger, longer-term ones (for home purchase) and thus the amount at stake is probably more than one percent of the loan portfolio.

a social welfare clause prohibiting the eviction of tenants resulted in a large decrease in the value of the property foreclosed, if inhabited. Since no data has been gathered on any actual residential mortgage foreclosures, even these time estimates are somewhat theoretical.

In the new law, the social welfare provision has been removed, recognizing that the banks should not have to be responsible for the social welfare of their defaulting clients; that is the proper role of the state. Eviction of the tenant, if necessary, is to be carried out by the local police, which is specifically obliged in the law to offer assistance to the courts. Once the mortgage is registered in the courts, it has first priority of lien with the exception of government liens for property taxes. Collateral limits include household possessions, 3 months of financial needs, and personal items.

The new law provides two mechanisms for executing foreclosure. One method is an adaptation of the mortgage foreclosure procedures contained in the old law. The major difference is that by consolidating some of the court procedures, the length of time needed to complete the process should be substantially shorter. The occupant of the unit in foreclosure may register protests, but they will not hold up the legal proceedings and are adjudicated together at one time. Once the court procedure is completed, the real estate is auctioned; the property must be free of inhabitants before the auction can take place.

The second mechanism available under the new law has been translated as “fiduciary foreclosure.” In contrast to the mortgage foreclosure option, fiduciary foreclosure permits the transfer the right of ownership to the lender in the event of loan default. The legal basis for fiduciary foreclosure is the contract signed between the lender and the creditor upon approval of the loan. The contract contains the terms upon which ownership of the property will be transferred to the bank and are freely negotiated between the two parties. In the current context of excess demand for credit this means that the bank can in effect dictate these terms to the borrower. The bank may stipulate, for example, that upon 30 days delinquency of two or more payments, the bank may take possession of the property directly without undertaking any court procedures. In other words, the fiduciary contract possesses the same legal authority as a court order, thus greatly simplifying and expediting the process of foreclosing on the property.

Once the lender has received legal title to the property, it may allow a landlord-tenant relationship with the debtor, but only upon agreement of the bank and on the bank’s terms. The bank also has the right to dispose of the property as desired. Eviction of the occupant, if necessary, is executed by the court based solely on the authority of the fiduciary contract. Auction procedures are identical for mortgage foreclosure described above.

Credit Culture

An important long-term trend in the development of housing finance and loan recovery in Croatia and CEE is the evolution of what has been termed the “credit culture;” in other words, how credit is treated from a social and cultural point of view. To understand the significance of the credit culture a key distinction must be made between loan repayment as an economic choice as opposed to a financial capacity on the part of the borrower. In most cases, loan repayment is a matter of economic choice, and subject to the borrower’s attitudes towards the alternatives available. In case of difficulty, such options may include selling his pledged property to repay the loan and adjusting to a more affordable situation, such as renting a smaller flat or moving in with relatives. However, in some cases the borrower may simply choose not to repay the loan and face the consequences.

A strong credit culture is a major ingredient to the success of loan recovery and the health of the financial system. When the consumer discovers that defaulting does not result in foreclosure on the property pledged, or that the legal system protects the borrower from any major consequences, the credit culture deteriorates.

An additional obstacle for the banks is the culture of bureaucracy developed in the previous period. Since banks were essentially controlled by the state or social enterprises, there exists a culture of “following the rules.” In the case of housing loans the loan departments within banks have strict underwriting guidelines which are followed scrupulously when considering a loan. In the case of loan recovery, loan officers only pursue recovery in the sense that they complete the paperwork in case of default in order to forward the case to the next department or the courts. After that, the job is considered complete and there does not seem to be much concern about the final outcome of the recovery process.

Croatia seems to be determined to strengthen its attitudes towards repayment. Banks are being cleaned of their bad loans and given new powers to collect on them and avoid making more of them. The recent legislation on foreclosure was specifically intended to indicate official backing for stronger recovery actions. It is still too early, though, to conclude how the management and staff of the banks, and the borrowing public, will react.